Supreme Court, U.S.
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No. 87-846

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

IN RE KENDAVIS HOLDING COMPANY AND KENDAVIS INDUSTRIES INTERNATIONAL, INC.,

Debtors

K. W. DAVIS, JR., ALANA LAWLER, ALANA LAWLER TRUST "A", A.T. DAVIS, A.T. DAVIS TRUST "A", KAY DAVIS, KAY DAVIS TRUST "A", TRICIA KAE LAWLER, ALANA LAWLER CHILDREN'S TRUST, ALLEN KENNETH DAVIS, JANIECE BREANNE DAVIS, A.T. DAVIS CHILDREN'S TRUST, KAY DAVIS CHILDREN'S TRUST, T.C. DAVIS, II, T. C. DAVIS, II TRUST, T.C. DAVIS, II TRUST "A", T.C. DAVIS, II TRUST "A" DATED JANUARY 15, 1982, BRIAN KEITH DAVIS, BRIAN KEITH DAVIS TRUST, BRIAN KEITH DAVIS TRUST "A", BRIAN KEITH DAVIS TRUST DATED JANUARY 15, 1982, CHESLEY DAVIS, CHESLEY DAVIS TRUST, TREY DAVIS, TREY DAVIS TRUST, KEN W. DAVIS FOUNDATION, AND TWALLA DUPRIEST, TRUSTEE FOR ESTATE OF T.C. DAVIS,

Petitioners

v.

THE OFFICIAL UNSECURED CREDITORS' COMMITTEES FOR KENDAVIS HOLDING COMPANY AND KENDAVIS INDUSTRIES INTERNATIONAL, INC., KENDAVIS HOLDING COMPANY, FEDERAL DEPOSIT INSURANCE CORPORATION, BANK OF NOVA SCOTIA, AND MBANK HOUSTON, N.A.

Respondents

REPLY BRIEF OF PETITIONERS

DAVID KLINE
RICHARD E. COULSON*
STEPHEN W. ELLIOTT
KLINE & KLINE
720 N.E. 63RD
OKLAHOMA CITY, OK 73105
(405) 848-4448
Attorneys for Petitioners

**Counsel of record*

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K. W. DAVIS, JR., ET AL.,

Petitioners

v.

OFFICIAL UNSECURED CREDITORS' COMMITTEES ET AL.,

Respondents

REPLY BRIEF OF PETITIONERS

Petitioners submit this brief in reply to the briefs filed by the Official Unsecured Creditors' Committees of Kendavis Holding Company and Kendavis Industries International, Inc. ("Committees"), Kendavis Holding Company ("KHC"), and The Bank of Nova Scotia ("Scotia").[1]

ARGUMENT IN REPLY

1. The Bankruptcy Judge Was Disqualified Under 28 U.S.C. § 455(a) and (b)(4) and the Order of Confirmation Should Be Vacated.

Respondents seriously misrepresent Petitioners' argument on a vital point. Petitioners do not charge a judge with a duty

[1] Of the other interested parties only the First Interstate Bank of California has responded by adopting the Committees' response.

to *insure* that he or she does not participate in any case in which he or she owns a financial interest in a party. Petitioners do argue that "the combination of § 455(b)(4)(1982) and the duty to be informed as to personal and fiduciary investments under § 455(c) establish a standard by which a judge is charged, conclusively, with knowledge of that which information in his possession reveals about his financial interest or which reasonable inquiry would reveal." Petition p. 15. Petitioners agree that the decisions in *Hodosh v. Block Drug Co., Inc.*, 790 F.2d 880 (Fed. Cir.), *cert denied*,____ U.S. ____, 107 S.Ct. 106 (1986) and *Union Carbide Corp. v. U.S. Cutting Serv., Inc.*, 782 F.2d 710 (7th Cir. 1986) were not vulnerable to attack on disqualification grounds. In neither case did the judge possess information disclosing that the judge's spouse owned stock in a party (in *Hodosh*, the judge's wife owned stock in a corporation which acquired an appellant pending appeal and, in *Union Carbide*, the judge's husband owned stock in two unnamed members of a 172,000 putative, uncertified class). *In re Indus. Gas Antitrust Litig.*, No. 80-C-3479 (N.D.Ill.E.D. Sept. 24, 1985), (Westlaw p. 2). There was no suggestion of oversight, neglect, or forgetfulness. In both cases the judge's duty was only to make reasonable inquiry as to the spouse's financial interest. Here the duty under § 455(c) is that the judge "should inform himself" of his own financial interests and Judge McGuire regularly received information revealing the ownership of Morgan Guaranty Trust Co. ("Morgan Guaranty") by J.P. Morgan Co., Inc. ("J.P. Morgan"). See Petitioners' Appendix pp. 19 and 25 ("Pet. App." hereafter).

Respondents also argue that Petitioners (and, inferentially, all Respondents, and other creditors including Morgan Guaranty) could have discovered Judge McGuire's financial interest by perusing his publicly-filed Financial Disclosure Reports and, thus, the objection comes too late. In *United*

States v. State of Alabama, 828 F.2d 1532 (11th Cir. 1987), the court addressed the timeliness question in an extensive footnote. 828 F.2d 1544, n. 49. The court noted some split of authority but stated "appellants did not discover relevant information about Judge Clemon's activities as a state legislator until late in the litigation, and raised this ground for disqualification at the first available moment." Similarly, in this case, after learning of the grounds for disqualification on March 23, 1987, Petitioners moved for relief on March 31, 1987. In no way did Petitioners delay after acquiring the disqualifying information. Although in *United States v. State of Alabama* the issue was raised before trial, the difficulty, complexity, and burdens on the parties of reversal would be identical with this case where it was promptly raised after acquiring knowledge (knowledge previously available to the trial judge).[2]

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[2] No party in these proceedings has alleged that Petitioners or any of their representatives at any time prior to March 23, 1987, knew that the judge owned stock in J.P. Morgan. Indeed, records kept by the bankruptcy clerk's office and acquired by other counsel for Petitioners, revealed that no party to this litigation had made inquiry prior to Judge McGuire's announcement on March 23, 1987, and that only one or two news gathering services had viewed such reports previously. This information is not of record but reveals some of the difficulties in denying Petitioners any relief without a due process hearing. Petitioners, in their *amici curiae* brief in *Liljeberg v. Health Servs. Acquisition Corp.* (Supreme Court docket No. 86-957), acknowledged that estoppel might be applicable to a party who had unreasonably delayed seeking the disqualification of a judge after the knowledge had been acquired. In this case, however, it is clear that Petitioners acted promptly in not only raising the issue but in attempting to discover all of the pertinent facts. In any event, the duty to recuse under 28 U.S.C. § 455 is that of the judge who in fact had all the pertinent information.

Respondents also suggest that compliance with 28 U.S.C. § 455(b)(4) by a bankruptcy judge may be extremely difficult in cases where there are tens of thousands of creditors. But the argument is inapposite. Here we are dealing with a signatory to the involuntary petition and a major and active creditor, which is one of 11 members of the KHC committee, one of 26 Class 7 creditors, and one of approximately 78 total creditors of KHC and KIII. See Respondents' Joint Appendix. pp. 15-17. ("Resp. Jt. App." hereafter).

2. The Petitioners Have Standing To Challenge Orders Entered By A Judge Disqualified Pursuant To 28 U.S.C. § 455 Which Order Cancelled Their Corporate Securities and Removed Them From Control of The Corporation.

Respondents contend Petitioners lack standing to challenge the orders confirming the plan of reorganization. Standing is absent, so Respondents say, because Petitioners are not aggrieved. They are not aggrieved, it is contended, because KHC is insolvent, the insolvency finding is not challenged, and, consequently, Petitioners do not stand to benefit from appellate review.[3] Below Respondents argue

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[3] Respondents allude to the failure of Petitioners to appear or object to proceedings in the bankruptcy court. The Petitioners at all times in the bankruptcy court proceedings were closely identified with the debtors KHC and KIII. The Petitioners were all of the shareholders of KHC, including the directors of KHC, and three of the Petitioners were the principal officers of KHC. Ken W. Davis, Jr., as president and chief executive officer and Kay Davis as corporate secretary of KHC, were present throughout the confirmation hearings and consistently worked with debtors' counsel in formulating the objections to the confirmation of the plan presented to the bankruptcy court. Where the identical objection and argument raised on appeal have been made by a similarly aligned party, the requirement of a second, "me too" objection serves no purpose. *Hormel v. Helvering*, 312

that under the "absolute priority rule" derived from *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939), and as modified by Bankruptcy Code § 1129(b), 11 U.S.C. § 1129(b) ("Code" hereafter), shareholders of an insolvent debtor corporation are not entitled to receive anything. But this is overly simplistic. *If and when* appropriate findings of certain predicate facts are entered by a judge not disqualified by interest, such shareholders *may* receive nothing in bankruptcy. But the predicate facts to such a result involve, *inter alia*, compliance with Code § 1129(a), requiring a host of judicial findings. 5 *Collier on Bankruptcy* ¶ 1129.03[e] (15th Ed. 1987) and G. Triester, J. Trost, L. Forman, K. Klee & R. Levin, *Fundamentals of Bankruptcy Law*, § 9.04(d)(2) (1986). Petitioners have contended that the plan confirmed did not meet Code § 1129(a) and that the judge making the requisite findings and entering the order of confirmation owned a disqualifying interest. If Petitioners' equity is to be cancelled,[4] they are entitled to have it done according to law and by a disinterested judge.

U.S. 552, 556-59; and *In re Brio Petroleum, Inc.*, 800 F.2d 469 (5th Cir. 1986). In any event, Petitioners separately raised the issue of judicial disqualification.

[4] Petitioners' rights to control the corporation, to seek to reorganize, to sell the stock (see e.g. *Jones v. McSpedden*, 560 S.W.2d 177 (Tex. Civ. App. 1977) (stock in an insolvent corporation is a sufficient consideration to support a contract)), to sell the assets (see e.g. *Calnan v. Guaranty Sec. Corp.*, 171 N.E. 830 (Mass. 1930) (shareholders of an insolvent corporation may sell the assets)) and to seek future business opportunities were also terminated by the bankruptcy court orders challenged herein. Bankruptcy courts have recognized that equity securities in a corporation with a negative balance sheet value are property of the estate and are not valueless. (*In re Landau Boat Co.*, 8 B.R. 436 (Bankr. W.D. Mo. 1981) and *In re Modern Glass Specialists, Inc.*, 42 B.R. 139 (Bankr. E.D. Wis. 1984)).

Moreover, standing to participate on any issue is granted by Code § 1109. The Petitioners herein are bound by the challenged orders. Code § 1141. If Petitioners are to be bound by the bankruptcy court orders, they are entitled to challenge those orders on appeal. *West v. Radio-Keith-Orpheum Corp.*, 70 F.2d 621, 623 (2nd Cir. 1934).

To deny Petitioners standing also results in a major shift of emphasis in chapter 11 corporate cases. "Usually bankrupts are insolvent . . . ." Jordan and Warren, *Bankruptcy* 2 (1985). If so, early in a case, senior creditors, by moving for a valuation of the estate, could override Code § 1109 and exclude equity security holders from participation. Rather than be encouraged to use chapter 11 to restructure debt, debtor corporations, under control of equity owners, would be reluctant to expose themselves to the possibility that filing would result in their exclusion from the reorganization process.

It is abundantly clear that both the "case or controversy" requirements of standing derived from article III of the United States Constitution,[5] and the prudential principles derived from concepts of judicial efficiency,[6] are satisfied here.

3. The Issues Presented In This Petition Are Not Moot.

Respondents argue that the issues presented herein have become moot while Petitioners' appeals were pending. If performance of a plan of reorganization renders appeals of the order of confirmation moot, then dissenting interest holders are effectively deprived of appellate review in the

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[5] *Simon v. Eastern Kentucky Welfare Rights Org.*, 426 U.S. 26 (1976).

[6] *Valley Forge Christian College v. Americans United for Separation of Church and State, Inc.*, 454 U.S. 464 (1982).

absence of a stay. In complex cases, such as this one, the discretionary denial of a stay, or onerous bonding requirements (a minimum of $300 million was requested by Respondent Committee in the Fifth Circuit) will result in appeals on grounds involving Code § 1129(a) usually becoming moot before appellate review can occur. Note, *Mootness on Appeal in the Supreme Court,* 83 Harv. L. Rev. 1672, 1692 (1970).

The Fifth Circuit did not rely on mootness. See Pet. App.-6. The alleged mootness is based on factors described in the Amended Affidavit of David E. Hawthorne. Resp. Jt. App.-12. These events were steps taken to implement the plan, or in some instances steps taken to accelerate the terms of the plan, and steps taken at the corporate subsidiary level independent of any plan provision. In summary, these steps are as follows: 43 holders of undisputed claims in Classes 1-5 have been paid about $1.5 million (or retain their claims unaffected by the plan). Nine holders of undisputed claims in Classes 6 were paid their first one-third installment of about $294,000. Resp. Jt. App. 16-17. Based on a motion to accelerate payment of the remaining installments to Class 6 creditors, the remaining Class 6 undisputed claims have been paid.[7] Remaining, disputed claims are being resolved.

The Committees' members and other institutional creditors fall in Class 7. These 26 creditors have received new KHC common and preferred stock, new KHC long- and short-term notes, and about $44.4 million in cash. Resp. Jt. App.-15-16. Additionally, KIII has been merged into KHC, new directors and officers have been selected for KHC, new directors have been selected for all KHC subsidiaries, and

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[7] The Petitioners have appealed to the district court the bankruptcy court order allowing this accelerated payment of $494,000. *In re Kendavis Indus. Int'l, Inc., et al.*, appeal docketed, No. CA3-87-2561-G (N.D. Tex. Dallas Div. 1987).

new officers have been selected for many KHC subsidiaries. Resp. Jt. App.-14, 18-20. Pending involuntary bankruptcy petitions against 12 KHC subsidiaries have been dismissed without prejudice. Other steps are described in the Amended Hawthorne Affidavit.

Petitioners agree that appeals are moot in bankruptcy cases where sufficient steps have been taken such that the appellate court could not give effective relief if reversal were in order.[8] But Respondents also argue that where a stay is not granted, a bankruptcy appeal case is mooted by substantial consummation. None of their cases support this proposition.

The rule of the cited cases and others is that an appeal becomes moot when new value is invested in the reorganized debtor by third parties who rely in good faith on the order appealed, where third parties necessary for appellate relief are not before the court, or where assets have been sold and no stay obtained. Indeed, Petitioners believe the sole test for mootness in such cases is whether the parties necessary for effective relief are before the court.[9] Nothing here calls for new value to be invested or the sale of assets pursuant to the plan. All parties necessary for effective relief are before the Court. Federal courts have adequate authority to retrieve consideration,[10] undo mergers,[11] or grant other appropriate

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[8] *Mills v. Green*, 159 U.S. 651 (1895).

[9] Where assets are sold and no stay obtained, the sale to a good faith purchaser may not be reversed. Code § 363(m). Thus the court cannot give effective relief when the sale is challenged and such an appeal becomes moot.

[10] *County of Dakota v. Glidden*, 113 U.S. 222 (1885).

[11] *Standard Oil Co. of New Jersey v. United States*, 221 U.S. 1 (1911); *United States v. Brown Shoe Co.*, 179 F.Supp. 721 (E.D. Mo. 1959), *aff'd* 370 U.S. 294 (1962); *Ramsburg v. American Inv. Co.*, 231 F.2d

relief where they have jurisdiction over the proper parties. Where some but not all matters are beyond effective appellate relief, the matters within the court's appellate control are not moot.[12] Here, all Class 7 creditors who have received or are to receive all the new common and preferred stock, long- and short-term notes totaling approximately $65.5 million, and all Available Cash, and whose aggregate claims of in excess of $500 million dwarf the remaining claims (see Committees' Brief p. 8, n. 3), are parties to the appellate process. There is no difficulty in this Court requiring the return of any consideration received by these parties or undoing the merger of KHC and KIII.

In any event, the "established practice of the Court in dealing with a civil case from a court in the federal system which has become moot while on its way here or pending our decision on the merits is to reverse or vacate the judgment below and remand with direction to dismiss." *United States v. Munsingwear*, 340 U.S. 36, 39 (1950). This is necessary "to prevent a judgment, unreviewable because of mootness, from spawning any legal consequences." *United States v. Munsingwear*, 340 U.S. at 41. Thus, if the Court believes the issues herein have become moot, Petitioners request this Court to grant the writ of certiorari, vacate the judgment, and remand the case to the court of appeals with instructions that the bankruptcy court dismiss the case as moot. *Delta Airlines, Inc. v. International Brotherhood of Teamsters, et al.*, ____ U.S. ____, 108 S.Ct. 53 (1987) and *Russoniello v Olheues*, _____ U.S. ____, 108 S.Ct. 52 (1987).

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333 (7th Cir. 1956); and *Fink v. Continental Foundry and Machine Co.*, 240 F.2d 369 (7th Cir. 1957).

[12] In re *AOV Indus., Inc.*, 792 F.2d 1140 (D.C. Cir. 1986) and *In re King Resources*, 651 F.2d 1326 (10th Cir. 1980).

CONCLUSION

Petitioners request this Court to grant a writ of certiorari and review the instant decision of the United States Court of Appeals for the Fifth Circuit on the merits or, alternatively and if this Court concludes the issues herein are moot, to grant the writ, vacate the orders below and remand to the Fifth Circuit with instructions to direct the bankruptcy court to dismiss the case.

Respectfully submitted,

DAVID KLINE
RICHARD E. COULSON*
STEPHEN W. ELLIOTT
KLINE & KLINE
720 N.E. 63rd
Oklahoma City, OK 73105
(405) 848-4448
Attorneys for Petitioners

* *Counsel of Record*